The Questionable Legality of the Diverted Profits Tax Under Double Taxation Conventions and EU Law

MacLennan, S

ISSN 0165-2826

Publisher: Kluwer Law International p

The Questionable Legality of the Diverted Profits Tax Under Double Taxation Conventions and EU Law

*Stuart MacLennan**

1. Introduction

On 3 December 2014, the United Kingdom's Chancellor of the Exchequer announced plans for a new Diverted Profits Tax.[1] In his Autumn Statement, the Chancellor informed the House of Commons that

> we will make sure that big multinational businesses pay their fair share. Some of the largest companies in the world, including those in the tech sector, use elaborate structures to avoid paying taxes. Today, I am introducing a 25% tax on profits generated by multinationals from economic activity here in the UK which they then artificially shift out of the country.[2]

The intended purpose of the tax is primarily to capture two kinds of offending behaviour. The first, is exploitation of mismatches between the tax systems of different countries in order to secure a deduction for tax purposes form UK profits for a transaction with a related non-resident enterprise that is not matched by a corresponding increase in the profits of said related non-resident enterprise. This is primarily a question as to the allocation of profits, affecting the practice of transfer pricing in particular. The second kind offending behaviour that the diverted profits tax seeks to address is the attribution (or non-attribution) of substantial profits earned within a jurisdiction to enterprises that lack a permanent establishment within that jurisdiction. This is primarily a question as to the appropriate nexus between the activities of an enterprise and a state in order to found jurisdiction to tax in the first place. Both such practices are perceived as being commonplace amongst enterprises that do the bulk of their business over the Internet (highly virtual enterprises), in particular, and led to the Diverted Profits Tax almost instantly being labelled the 'Google Tax'.[3]

This article considers the tax in three parts. The first details the legal basis for the Diverted Profits Tax, and considers how it will be operated and enforced. The second considers the compatibility of the tax with the UK's obligations under Double Taxation Conventions to which the UK is a party, in particular whether it is sufficiently similar to Corporation Tax as to be subject to such conventions. The final part of this article considers the tax in light of a series of judgements of the European Court of Justice that have taken a dim-view of anti-avoidance provision that inhibit the free movement of capital and freedom

*Assistant Professor, China-EU School of Law and Arthur Cox Research Scholar, School of Law, Trinity College, Dublin.

[1] Financial Times, 'UK targets multinationals with "diverted profit" tax' <http://www.ft.com/intl/fastft/245411/uk-targets-multi-nationals-with-diverted-profit-tax> 3 December 2014.

[2] HC Deb 2 Dec 2014, vol. 79, col. 309.

[3] The Guardian, 'What is the 'Google tax'?' <http://www.theguardian.com/politics/2014/sep/29/what-is-google-tax-george-osborne> 29 September 2014; BBC, 'Osborne - Benefit freeze and "Google tax"' (2014) <http://www.bbc.com/news/uk-politics-29411686> 29 September 2014; Financial Times, 'Osborne plans crackdown on tech groups with new anti-avoidance rules' <http://www.ft.com/cms/s/0/f0564d62-4803-11e4-b5ad-00144feab7de.html> 29 Spetember 2014.

of establishment within the European Union. This article concludes that the Diverted Profit Tax's compatibility with the UK's obligations under Double Taxation Conventions is extremely questionable; while the tax is only compatible with European Union Law insofar as it applies to wholly artificial arrangements.

2. Operation and enforcement

The Diverted Profits Tax is designed to address transactions which, in the opinion of Her Majesty's Revenue and Customs (HMRC),, lack economic substance;, as well as contrived arrangements which avoid a UK permanent establishment. Where an arrangement is deemed to be so contrived, a charge to tax is applied upon the profits that would otherwise be chargeable to UK Corporation Tax but for the existence of the contrived arrangement. The tax was introduced in the Finance Act 2015 ('the Act') and becomes chargeable upon 'diverted profits' when four conditions are met: the participation condition; the mismatch condition; the tax avoidance condition; and the no economic substance condition.

The participation condition requires that the parties to a transaction or series of transactions be connected. The wording of the participation condition is similar to that used in the transfer pricing rules in the Taxation (International and Other Provisions) Act 2010, requiring that one of the parties be directly or indirectly participating in the management, control, or capital of the other.

The mismatch condition requires that 'the material provision results in an effective tax mismatch outcome'[4] between the UK and foreign parties. Where, as a result of a transaction or series of transactions with a foreign party, the expenses of a UK party increase, and the taxable income of that party decreases, that decrease ought to result in a corresponding increase in the taxable income of the foreign party. Where the reduction in the tax liability (not the taxable profits) of the UK party are not met by a corresponding increase in the foreign party's tax liability (including withholding tax), the mismatch condition is satisfied. However, the mismatch condition is not satisfied where the amount paid by the second party[5] exceeds 80% of the reduction in the UK party's tax liability.

The tax avoidance condition is met where the main purpose of an arrangement is deemed to be the avoidance of a charge to tax in the UK.

The insufficient economic substance condition requires that a comparison be made between the value of the tax reduction resulting from the tax mismatch outcome and any other financial benefit that results from the transaction or series of transactions. The condition can be satisfied where the tax reduction referable to the transaction or series of transactions is greater than any other financial benefit and that it is reasonable to assume that the transaction was designed to secure that reduction. The condition is also satisfied where the overall contribution of value to a transaction is less than the value of the tax reduction, and it is reasonable to assume that the transaction(s) was or were designed to secure the reduction.

[4] s.86(2) Finance Act 2015.
[5] Or the amount that would have been paid but for the application of loss relief.

There are two parts to the Diverted Profits Tax nexus: a qualitative standard – the 'avoided permanent establishment' (avoided PE) – and a quantitative standard – a simple turnover threshold. An avoided PE is deemed to exist where an enterprise that is non-resident in the UK carries on a trade, and that that enterprise

> whether or not UK resident, is carrying on activity in the United Kingdom in that period in connection with supplies of services, goods or other property made by the foreign company in the course of that trade

and that it is

> reasonable to assume that any of the activity of the avoided PE or the foreign company (or both) is designed so as to ensure that the foreign company does not, as a result of the avoided PE's activity, carry on that trade in the United Kingdom for the purposes of corporation tax.

Perhaps most remarkably, the avoided PE is also deemed to exist regardless of whether or not the activity of the foreign company is also designed to secure any other objective. This provision applies regardless of whether or not the prevailing purpose of the arrangement was something other than to avoid a UK taxable presence, and whether or not that arrangement reflects genuine economic activity. This raises considerable questions as to the provisions' compatibility with EU law, discussed below.

s.87 of the Act provides that an avoided PE does not exist where the value of the sales of the enterprise generated from the United Kingdom does not exceed £10,000,000, or where the value of the expenses of the enterprise incurred in the United Kingdom does not exceed £1,000,000. It is clear, therefore, that the tax is intended to target only enterprises that are, at a minimum, reasonably large.

Rather than modifying existing permanent establishment rules, the Act instead creates a new PE fiction: an 'avoided PE'. A unilateral action by the United Kingdom to amend permanent establishment rules across the board would certainly place it in breach of its obligations under the numerous Double Tax Conventions to which it is a party. While the Diverted Profits Tax is not a redefinition of the permanent establishment standard, it is a supplement to the existing standard. It is therefore certainly questionable whether or not the avoided PE standard is consistent with the United Kingdom's treaty obligations.

The provisions of Part 3 of the Finance Act 2015 providing for the Diverted Profits Tax came into effect on the 1 April 2015. At the time of writing the operation and effects of the tax are not entirely clear.

An oft-cited challenge for the Diverted Profits Tax is that of enforcement. Though academic scrutiny of the Diverted Profits Tax is somewhat limited at present,[6] a number of practitioners have questioned how effectively HMRC can enforce the tax against enterprises that lack a permanent establishment in the United Kingdom. However, this seems somewhat specious for two reasons. First, it is not necessary for an enterprise to have a UK permanent

[6] See Picciotto, 'The UK's diverted profits tax: an admission of defeat or a pre-emptive strike?', *Tax Notes International* (2015): 239-242, Self, 'The UK's New Diverted Profits Tax: Compliance with EU Law' *Intertax* (2015): 333–336.

establishment in order to be subject to UK VAT, yet this appears to pose few problems to the operation of VAT. Second, there is little reason to believe that companies will seek to break the law.

Schedule 16 of the Act provides for the collection and enforcement of the Diverted Profits Tax. Part 1 of the Schedule applies the provisions of Chapter 6 of Part 22 of the Corporation Tax Act 2010 to the collection and enforcement of the Diverted Profits Tax, with 'permanent establishment' to be read as 'avoided permanent establishment'.[7] Part 2 of Schedule 16 allows for the revenue to enforce the collection of the tax against related companies. A company is deemed to be a related company where the company is a member of the same group as the taxpayer company, of a consortium which at that time owned the taxpayer company, of the same group as a company which at that time was a member of a consortium owning the taxpayer company.

However, one of the most striking characteristics of the Diverted Profits Tax is its rate. While in the financial year commencing 1 April 2015 the UK's headline rate of Corporation Tax is 20%, the Diverted Profits Tax is chargeable at a rate of 25%. It would appear from this that the objective of the Diverted Profits Tax is not simply to capture profits that are being diverted out of the UK and bring them within a charge to tax, but to actively discourage companies from diverting profits in the first place. A company can avoid paying the Diverted Profits Tax by instead accounting for those diverted profits as chargeable to UK Corporation Tax, thereby subjecting those profits to a charge of 20%, rather than 25%. If the DPT is successful in encouraging companies to account for profits in the UK, rather than diverting them elsewhere, then it is likely that the DPT itself will raise very little revenue, and result in very little enforcement.

The DPT is notable for its broad scope. However, the breadth of the DPT's application raises questions as to the enforceability of the tax, as well as its compatibility with the UK's obligations under its Double Tax Treaties. Clifford Chance highlights the possibility that unilateral action by the United Kingdom may trigger a response from other countries:

> if this is not part of a coordinated action then other governments may take a dim view of the UK taking such a dramatic unilateral action. We could see retaliatory measures introduced, particularly in the US.[8]

In some respects the Diverted Profits Tax represents something of an historical re-tread – albeit this time on the other side of the Atlantic. In the mid 1980s, amidst concerns about the tax practices of MNEs, no fewer than a dozen US states had enacted a system of unitary taxation – including California. This attracted the ire of numerous foreign government ministers – most prominent among them being the British Prime Minister, Margaret Thatcher. Mrs Thatcher is reported to have considered US states' systems of unitary taxation to be a 'serious' issue, having raised the matter with President Reagan on a number of occasions.[9]

---

[7] Sched. 16, para. 1(3).
[8] Clifford Chance, The UK diverted profits tax: final legislation published (2015) p.9.
[9] New York Times, 'Unitary Tax Under Fire' 2 November 1983 D 2, Alex Brummer, 'US President encouraged to ban unitary taxation' *The Guardian* (London, 1/8/1984), David E. Rosenbaum, 'U.S. Expected to Act to Limit Unitary Taxation' *New York Times* (New York, 23/10/1985) D 2.

Such was the United Kingdom's opposition to unitary standards adopted in the US that enacted retaliatory provisions in the Finance Act 1985. s54 of the Act reduced the entitlement of companies (or associates of companies) with a taxable presence in unitary jurisdictions to double taxation relief under a Double Taxation Convention to half of that which it would be were they resident in the United Kingdom or other water's edge jurisdiction.[10]

What can be gleaned from US states' dabblings with unitary taxation is that it is highly unlikely that other governments will simply ignore the attempts by one state to extend their fiscal reach into the jurisdiction of another. After all, it is usually more than mere accident that it is those states to which companies are purportedly 'diverting' their profits in which such companies find themselves resident. Usually, those countries have structured their tax systems specifically in order to facilitate such diversions. That being the case, it is unlikely that those jurisdictions will be any happier with the erosion of their tax base or inward investment any more than the UK is with the erosion of theirs. The United Kingdom was the most vocal opponent of such action in the 1980s, and it is highly likely that the UK Treasury will face similar criticism from treaty partners whose corporate residents will be subject to the DPT.

However, it might also be the case that other states – in particular those for whom base erosion is an increasing problem – will be looking keenly upon the United Kingdom's experiment with the DPT, in the hope that it provides a solution to their own base erosion problems. Australia has already indicated that intends to follow the UK in implementing similar arrangements. If other major economies were to follow suit, it could well be that some of the onus to implement the OECD's BEPS agenda is removed.

3. Compatibility with OECD Model

Of some question is the compatibility of the Diverted Profits Tax with the United Kingdom's tax treaty obligations. The typical UK tax treaty is closely modelled on the OECD Model convention, with most Articles 5 and 7 (or their equivalents) being either verbatim transpositions of their OECD Model counterparts, or else containing only minor modifications.[11]

The typical UK Double Tax Convention therefore provides that the

> [p]rofits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein.

[10] 'This section applies to a company which has, or is an associated company of a company which has, a qualifying presence in a unitary state and, at any time when it or its associated company has such a qualifying presence, is entitled by virtue of arrangements having effect under section 497(1) of the Taxes Act (relief by agreement with other countries) to a tax credit under section 86 of the Finance Act 1972 (tax credit for certain recipients of qualifying distributions) in respect of qualifying distributions made to it by companies which are resident in the United Kingdom which is equal to one half of the tax credit to which an individual resident in the United Kingdom would be entitled in respect of such distributions.'

[11] For example, the UK-Ireland and UK-Norway DTCs both contain additional permanent establishment thresholds in order to provide for offshore extraction of natural resources.

The typical definition of a permanent establishment contained therein closely resembles the OECD definition discussed at length, above. The threshold standard contained within the Finance Act 2015 effectively supplements accepted permanent establishment definitions with an additional threshold standard – the 'avoided PE'. In this respect, the 'avoided PE' standard is not dissimilar from other permanent establishment fictions – such as the offshore oil fictions that exist in the UK-Norway and UK-Ireland treaties. Installations that would not otherwise fall within the scope of one or the other's state's taxation by virtue of not meeting all of the criteria necessary to constitute a permanent establishment (such as being 'fixed') are brought within the scope of that state's taxation by defining a permanent establishment fiction. However, unlike other fictions, the 'avoided PE' fiction is not created by treaty, but by the unilateral action of the Parliament of the United Kingdom,

HMRC takes the (unsurprising) view that the Diverted Profits Tax is compatible with the United Kingdom's obligations under Double Tax Conventions, for two reasons. The first, is that

> the entry conditions for the diverted profits tax mean that it will only be applied to arrangements designed to exploit the provisions of tax treaties to avoid tax. Therefore the arrangements it targets are the kind where there is no obligation to provide relief under international law.[12]

There are two potential entry conditions, satisfaction of either of which will result in a charge to tax.[13] The first entry condition is the mismatch condition – that is to say that in order for the charge to tax to apply a reduction in the profits of the avoided PE has taken place that is not matched by a corresponding increase in profits of the corresponding related party.[14] In this instance, the position of HMRC is somewhat convincing, as such mismatches normally occur as a consequence of the exploitation of gaps between the tax systems of the two contracting jurisdictions, which has not been addressed by the treaty. For example, where the United Kingdom offers a deduction an enterprise's UK profits for a transfer made to a related Irish enterprise, but Ireland considers that transfer to be attributable to the profits of the UK enterprise, no tax will be payable on those profits at either end. This is an example of profits 'falling through the gap' between the parties' respective tax systems. As such arrangements seek to exploit gaps in the parties' respective tax systems and the treaty between them, it would therefore appear that such arrangements do indeed fall outwith the ambit of Double Taxation Conventions, and as such contracting states are at liberty to extend whatever tax treatment they so wish to such arrangements.

However, the submission that the entry conditions for the Diverted Profits Tax place the tax outwith the ambit of Double Taxation Conventions is more difficult to sustain where the tax avoidance condition is concerned. The tax avoidance condition is met where 'main purpose or one of the main purposes of which is to avoid or reduce a charge to corporation tax.'[15] In the first scenario, the charge to tax only applies where there is a mismatch in the tax treatment of the avoided PE and the non-resident enterprise – in effect, a gap in the treaties – then it is the case that Diverted Profits Tax falls outwith the scope of Double Tax

[12] HMRC, 'Diverted Profits Tax' (The Royal Society, London, 8 January 2015).
[13] Provided that certain other criteria are met.
[14] s.107.
[15] s.86(3).

Conventions. However, in the second scenario, there need not necessarily be a mismatch in the treaties, but merely that the purpose of the arrangement is to avoid a charge to UK corporation tax. Where the tax avoidance condition is concerned, it is entirely possible (indeed likely) that an arrangement that has as its purpose or one of its main purposes to avoid or reduce a charge to corporation tax is nonetheless an arrangement that falls within the ambit of both states' tax systems and of the Double Tax Treaty between them. The tax avoidance condition is satisfied not by reference to fact, but to purpose. However, neither the OECD Model Convention, nor any of the UK's Double Taxation Conventions provide for any consideration of purpose. Determinations as to the jurisdiction to tax under tax treaties are entirely the product of a factual inquiry. It is difficult, where the tax avoidance condition is concerned, to see how a charge to tax that applies where there is no mismatch in the parties' respective tax treatment, but simply that the arrangement is a contrived to minimise a party or the parties' tax liability, is not in breach of treaty obligations.

The second argument that HMRC makes for the compatibility of the Diverted Profits Tax with the UK's international obligations is that notwithstanding the above concerns, the Diverted Profits Tax falls outwith the scope of the relief available under the UK's Double Tax Treaties, as such treaties offer relief only insofar as Income Tax, Corporation Tax, and Capital Gains Tax is concerned.[16] HMRC takes the view that the Diverted Profits Tax is a new tax, and not merely an extension of the scope of one or more of the aforementioned taxes, it therefore falls outwith the scope of the tax treaties.

However, the Association of Chartered Certified Accountants (ACCA) has questioned this defence, stating that '[j]ust because the UK says the DPT is not corporation tax, this does not mean that other jurisdictions will accept it as such'.[17] Indeed, the position of HMRC in this respect is difficult to sustain. A great many of the UK's Double Taxation Conventions – including those between the UK and France, Germany, the U.S., Ireland, and the Netherlands – provide that those conventions

> shall also apply to any identical or substantially similar taxes which are imposed by either Contracting State after the date of signature of this Convention in addition to, or in place of, the taxes of that Contracting State referred to in paragraph (1) of this Article.

As the Diverted Profits Tax is a supplement to Corporation Tax, it is therefore necessary to consider whether the Diverted Profits Tax is 'identical or substantially similar' to Corporation Tax.

The question of whether or not a supplementary tax charge was so substantially similar to Corporation Tax as to fall within the scope of the UK's Double Taxation Conventions was considered in *Bricom v Commissioners of the Inland Revenue.*[18]

Bricom concerned the UK's implementation of controlled foreign corporation (CFC) rules. In general, the UK levies corporation tax over companies that are resident in the United

---

[16] HMRC, 'Diverted Profits Tax', *supra* note 12.
[17] Accountancy Age, ''Google tax' may be extra-territorial, warns ACCA' <http://www.accountancyage.com/aa/news/2386020/-google-tax-may-be-extra-territorial-warns-acca> 10 December 2014.
[18] *Bricom v. Commissioners of the Inland Revenue* [1997] BTC 471.

Kingdom,[19] and non-resident companies who trade in the UK through a permanent establishment. It would not normally levy corporation tax over companies that are neither resident nor lack a permanent establishment in the UK. However, under the UK's CFC rules, HMRC may impute the profits of such non-resident corporation where it

> (a) is resident outside the United Kingdom, and
>
> (b) is controlled by persons resident in the United Kingdom, and
>
> (c) is subject to a lower level of taxation in the territory in which it is resident.[20]

The test is not a mechanical one based simply on, for example, shareholding or voting rights. The test is intended to establish whether a person has the power to ensure that the affairs of a company are conducted in accordance with his wishes. If such power is exercisable only as a result of share holding, it is to the shareholdings that one would look to determine control but it will not be a simple mechanical or mathematical test.[21] In the case of *Bricom,* however, it was not disputed that the subsidiary in question was a CFC.

The CFC rules require that where a non-resident company is found to be a CFC, the chargeable profits and creditable tax of that company

> shall each be apportioned […] among the persons (whether resident in the United Kingdom or not) who had an interest in that company at any time during that accounting period.[22]

s.747(4) requires that where such an apportionment is to take place, the controlling resident company shall have imposed upon it a charge equivalent to the corporation tax that would be payable by the CFC were it resident in the UK. Schedule 24 provides for the fictional assumption that the company is resident in the UK.

In *Bricom*, the CFC in question was resident in the Netherlands. The taxpayer (Bricom) contested its liability under the above provisions on the basis of the Double Taxation Convention between the United Kingdom and the Kingdom of the Netherlands. The basis for this contention was that the under Article 11 of the convention, the income imputed to the CFC (in this case interest income derived and beneficially owned by a resident of a Contracting State) is taxable only in the State in which the company is resident. Bricom further contested that as the CFC charge was 'identical or substantially similar' to corporation tax, under Article 2(1) it fell within the scope of the Convention and was therefore prohibited.

The basis for the taxpayer's contention in *Bricom* is the fact that the apportionment under s.747(3) is not 'a sum equal to the chargeable profits' but the chargeable profits

[19] That is, where the company's place of effective management is located in the UK, as opposed, necessarily, to its place of incorporation. See *De Beers Consolidated Mines Ltd v Howe (Surveyor of Taxes)* [1906] AC 455.

[20] s.747(1) Income and Corporation Taxes Act 1988 [hereinafter 'ICTA'].

[21] HMRC, 'INTM202020 - Controlled Foreign Companies: definitions' <http://webarchive.nationalarchives.gov.uk/+/http://www.hmrc.gov.uk/manuals/intmanual/INTM202020.htm>.

[22] s.747(3).

themselves. The court, however, queried that contention, viewing the chargeable profits as a 'purely notional sum', finding that

> [t]hey do not represent any of the profits of [the CFC] on which corporation tax is chargeable, for there are no such profits. […] They are merely the product of a mathematical calculation made on a hypothetical basis and making counterfactual assumptions. […]What is apportioned to the taxpayer and subjected to tax is not [the CFC's] actual profits but a notional sum which is the product of an artificial calculation.[23]

The court makes a semantic distinction between assessment of profits actually accrued, and assessment of notional sums deemed to represent profits actually accrued. The court therefore held that the charge to tax under the CFC rules was not 'identical or substantially similar' to corporation tax and was therefore not prohibited by the UK-Netherlands Double Taxation Convention.

However, it is submitted that at a conceptual level this is an unsatisfactory decision. The court distinguishes between actual accrued profits and notional imputed profits. In the context of multi-national enterprises, this appears to be an odd distinction to make – as the assessed profits of most multi-national enterprises are, in fact, notional sums – the product of assumptions and fictions in order to calculate what the profits of that enterprise *would be* if it traded with its non-UK parts on an arm's length basis. The distinction between the imputed profits of a non-resident but controlled foreign corporation, and the assessed profits of a resident subsidiary appears to be a question of accuracy. The profits of the latter may well be a more sophisticated fiction than the profits of the former, but nonetheless, they are both a fiction.

However, notwithstanding the unsatisfactory nature of the decision in *Bricom* it remains highly arguable that applying the same approach to the Diverted Profits Tax may well produce a different outcome.

s.747(4) ICTA provides for the recovery of 'a sum equal to corporation tax at the appropriate rate on that apportioned amount of profits' . s.747(6) defines the profits that are to be attributed to the CFC as

> the amount which, on the assumptions in Schedule 24, would be the amount of the total profits of the company for that period on which, after allowing for any deductions available against those profits, corporation tax would be chargeable.

However, the charging provisions in the Finance Act 2015 are arguably less circumspect than the CFC provisions of the ICTA. s.88(5) of the Finance Act 2015 provides that the taxable profits of the 'avoided PE' are

> the profits which would have been the chargeable profits of the foreign company for that period, attributable (in accordance with sections 20 to 32 of

[23] *Supra* note 18.

> [Corporation Tax Act] 2009) to the avoided PE, had the avoided PE been a permanent establishment in the United Kingdom.

The approach of the Finance Act 2015 is to directly import the charging provisions from the Corporation Tax Act 2009. This approach is therefore somewhat less reliant upon assumptions and fictions than the approach taken to CFCs. It is therefore arguable that accepting the court's distinction in *Bricom* between actual accrued profits and notional imputed profits – the profits subject to the Diverted Profits Tax are closer in character to the former kind of profits than the latter. HMRC might well find it considerably more difficult to defend the position that a tax payable upon the base defined by the Corporation Tax Act 2009 is not identical or substantially similar to Corporation Tax itself.

While HMRC maintains that the Diverted Profits Tax is formally distinct from Corporation Tax, the only discernable differences between them appear to be the jurisdictional standard triggering the charge to tax, which is problematic with respect to the UK's tax treaty obligations; and the rate at which the tax is payable – 25%, as opposed to a 20% rate of Corporation Tax in 2016-16, which might also be problematic with respect to European Union Law.

4. Compatibility with European Union Law

The courts of the European Union have consistently and repeatedly impugned laws that treat a company differently because they have shifted their residence, establishment, or source of income – even when such relocations have as their objective the minimisation or avoidance of tax.[24] It is settled case law that as a matter of European Union Law, direct taxation falls within the competence of the Member States. However, Member States must nonetheless exercise that competence in accordance with the broader requirements of European Union Law.[25] Of particular relevance is Article 110 TFEU which provides that

> [n]o member state shall impose, directly or indirectly, on the products of other Member States any internal taxation of any kind in excess of that imposed directly or indirectly on similar domestic products.[26]

Of further relevance to corporations, in particular, is the provisions of Article 49 TFEU, which prohibits restrictions upon freedom of establishment of nationals of Member States in the territory of another Member State. This includes establishment and management of undertakings, including companies.[27] Furthermore, Article 63 TFEU provides for the free movement of capital within the Union.

[24] Gordon, 'Tax Competition and Harmonisation under EU Law: Economic Realities and Legal Rules' *European Law Review* (2014): 790.
[25] Case C-311/97 *Royal Bank of Scotland* [1999] ECR I-2651; Case C-319/02 *Manninen* [2004] ECR I-7477; Case C-446/03 *Marks & Spencer* [2005] ECR I-10837.
[26] Art. 110, Consolidated Version of the Treaty on the Functioning of the European Union, 2008 O.J. C 115/47.
[27] Art. 54, TFEU.

It is arguable that the Diverted Profits Tax may well breach EU Law in this respect. In a similar fashion to CFCs, the nature of the Diverted Profits Tax is such that it can only apply to a non-resident company.

The decision of both the ECJ and of the Advocate General in *Sandoz*[28] are informative in this respect. *Sandoz* concerned the requirement to pay Austrian stamp duty on loans. A distinction existed between loan agreements drawn up and executed within Austria, and those executed outwith Austria. Austrian legislation further provided that where a loan was drawn up outwith Austria, and not recorded in a written instrument that is chargeable for the purposes of stamp duty, that company books kept in Austria in which the loan is recorded shall be deemed to be such an instrument for the purposes of stamp duty. This 'deeming' of transactions concluded outwith Austria to be chargeable upon the books of the Austrian enterprise could be argued to be analogous to the deeming of transactions to be attributable to an avoided PE under the Diverted Profits Tax. It is worth noting that the Austrian legislation in *Sandoz* did not impose a higher duty on loans arranged outwith Austria, or even less favourable terms.[29] Nonetheless, the Court in *Sandoz* found that Austria's extension of its jurisdiction to tax such loan transactions was a breach of Articles 56 and 58 TFEU.

In his opinion on the case, Advocate General Leger took the view that

> [t]he principle of the free movement of capital was introduced *inter alia* in order to enable Community nationals to enjoy the most favourable conditions for investing their capital available to them in any of the States which make up the Community.[30]

It is difficult to conclude that Advocate General Leger's opinion is anything other than an endorsement of tax competition between Member States. The Court agreed with the Advocate General's position, holding that the measure

> deprives residents of a Member State of the possibility of benefiting from the absence of taxation which may be associated with loans obtained outside the national territory. Accordingly, such a measure is likely to deter such residents from obtaining loans from persons established in other Member States.
>
> It follows that such legislation constitutes an obstacle to the movement of capital within the meaning of Article [63 TFEU].[31]

If the very purpose of free movement is to ensure the allocation of resources to their most efficient location, it logically follows that measures which inhibit 'shopping around' for the most favourable environment for those resources must surely be unlawful.

---

[28] *Sandoz* (C-439/97) [1999] E.C.R. I-07041.
[29] If anything, the charging provisions for loans arranged outwith Austria were more favourable than those arranged within Austria – being payable only at the point at which the loan instrument is brought into Austria, rather than the point at which the loan instrument is executed.
[30] Case C-439/97 *Sandoz*, Opinion of Advocate General Leger [1999] ECR I-7043, para. 47.
[31] *Supra* note 28.

The question of whether or not the UK's CFC rules are compatible with EU Law was considered by the ECJ in *Cadbury Schweppes*.[32] At issue in the case was the question of whether or not the UK's taxation, under certain conditions, of the profits of subsidiaries established outside of the United Kingdom is compatible with EU Law.

Much like the Diverted Profits Tax, the CFC rules are designed specifically to target attempts to take advantage of lower tax rates in other jurisdictions. Similarly, much like the Diverted Profits Tax, the CFC rules do not apply where a 'motive' test is satisfied. In the case of CFCs, the motive test is satisfied when two cumulative conditions are met. The first, is that where the transactions which are attributable to the CFC produce a reduction in the UK tax payable compared to that which would have been payable absent those transactions, and where that reduction exceeds a certain threshold, the company must show that the reduction to UK tax was not the main purpose, or one of the main purposes, of those transactions. The second criterion is that the company must show that it was not the main reason, or on of the main reasons, for the CFC's existence to achieve a reduction in UK tax by diverting profits thereto.[33]

The Diverted Profits Tax becomes chargeable under s.86 of the Finance Act 2015 where a non-UK resident company avoids a UK taxable presence and, among other criteria, either the tax avoidance condition or the mismatch condition is satisfied. The mismatch condition occurs where the arrangements between the two enterprises results in an effective tax mismatch outcome. This effective tax mismatch outcome is remarkably similar to the CFC provisions contained within ICTA. An effective tax mismatch outcome exists where there has been a deduction from the taxable profits of a UK enterprise that is not matched by a corresponding increase in the taxable profits of the related non-UK company, and the 80% payment test is not met. This 80% payment test is met where the resulting increase in relevant taxes payable by the non-UK company as a result of the attribution of aforementioned payment to it is at least 80% of the amount of the resulting reduction in the amount of the relevant tax payable by related UK enterprise.

The decision in *Cadbury Schweppes* is of considerable significance insofar as the 80% payment test is concerned. The Court in *Cadbury Schweppes* reiterated its earlier pronouncement in *Barbier* that

> a Community national cannot be deprived of the right to rely on the provisions of the Treaty on the ground that he is profiting from tax advantages which are legally provided by the rules in force in a Member State other than his State of residence.[34]

The Court had previously held that the right of freedom of establishment guaranteed by the EU Treaties means that the fact that an enterprise has sought to establish itself in a

[32] Case C-196/04 *Cadbury Schweppes* [2006] ECR I-8031.
[33] s.748(3) ICTA.
[34] Case C-364/01 *Barbier* [2003] ECR I-15033, para. 71.

Member State in order to take advantage of a more favourable legislative environment does not, of itself, constitute an abuse of that freedom.[35]

In *Commission v. France* the Court held that the fact that a company gains a tax advantage by establishing in a Member State cannot of itself justify the imposition of disadvantageous tax treatment by another Member State.[36] Furthermore, the Court took an unequivocal view of Article 54 TFEU, stating that the objective of preventing tax avoidance does not permit a state to restrict a company's right of freedom of establishment:

> [t]he risk of tax avoidance cannot be relied upon in this context. Article [54 TFEU] does not permit any derogation from the fundamental principle of freedom of establishment on such a ground.[37]

The ECJ appears to have taken a fairly consistent approach to the conflict that arises between, on the one hand, the right of freedom of establishment enshrined within Article 54 TFEU; and, on the other, national rules which are designed to combat tax avoidance but incidentally infringe upon Article 54.

In *ICI* the Court held that

> diminution of tax revenue occurring in this way is not one of the grounds listed in Article [52 TFEU] and cannot be regarded as a matter of overriding general interest which may be relied upon in order to justify unequal treatment that is, in principle, incompatible with Article [49 TFEU].[38]

This unequivocal approach is further elaborated by the Court in *Cadbury Schweppes*:

> the mere fact that a resident company establishes a secondary establishment, such as a subsidiary, in another Member State cannot set up a general presumption of tax evasion and justify a measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty.[39]

It is clear, therefore, that the objective of preventing tax avoidance does not justify any restriction upon an enterprise's right to freedom of establishment. Furthermore, the

---

[35] Case C-167/01 *Inspire Art* [2003] ECR. I-10155, para. 105: 'The reasons for which the company was formed in that other Member State, and the fact that it carries on its activities exclusively or almost exclusively in the Member State of establishment, do not deprive it of the right to invoke the freedom of establishment guaranteed by the Treaty, save where abuse is established on a case-by-case basis.' See also Case C-212/97 *Centros* (C-212/97) [1999] E.C.R.ECR I-01459, para. 27.

[36] Case 270/83 *Commission v. France* [1986] ECR 273, para. 21.

[37] *Ibid*, para. 25.

[38] Case C-264/96 *ICI* [1998] ECR I-04695, para. 28.

[39] *Supra* note 31, para. 50. This is further articulated by the Court in Case C-311/08 *SGI* [2010] ECR I-487: 'a national measure restricting freedom of establishment may be justified where it specifically targets wholly artificial arrangements designed to circumvent the legislation of the Member State concerned'; and Case C-282/12, *Itelcar* [2013] ECR I-0000: 'a national measure restricting the free movement of capital may be justified where it specifically targets wholly artificial arrangements which do not reflect economic reality and the sole purpose of which is to avoid the tax normally payable on the profits generated by activities carried out on the national territory.'

objective of reducing liability to pay tax cannot, of itself, be considered to be abusive of that right.[40]

The test provided for in Cadbury Schweppes therefore has two constituent elements:

> a subjective element (the intention to escape the tax due), and an objective element (showing that the objectives of the freedom of establishment have not been activated).[41]

Under the second element, such anti-avoidance rules may not be applied, even where there is an explicit *intention* to avoid tax, where the taxpayer nonetheless carries on genuine economic activities.[42]

Indeed, Gordon argues that competition between jurisdictions to attract businesses by way of favourable regulatory and taxation regimes is not only compatible with the core principles of the Internal Market, but encouraged by them.[43] On that basis it is further arguable, therefore that the objective of the Diverted Profits Tax is not so much the elimination of abusive practices or tax avoidance, but of lawful tax competition between states. A position that is made all the more indefensible by virtue of the Chancellor of the Exchequer's continued cuts to the UK's main rate of Corporation Tax.

However, even if the Diverted Profits Tax were to survive challenges on the basis of the UK's obligations under International and EU Law – the question remains as to whether or not the tax will have any serious practical effect. As it is quite clear that EU Law permits the scope of such a tax to be only so wide as to capture wholly artificial arrangements, it is arguable that, in fact, very few companies will ever be required to pay it. Under the two-part test outlined in *Cadbury Schweppes* and discussed *supra*, even prohibitions on arrangements that have as their intention the avoidance are not compatible with EU law where such arrangements are nonetheless rooted in economic reality. The test of whether or not an arrangement is based upon economic reality

> must be based on objective factors which are ascertainable by third parties with regard, in particular, to the extent to which the [company] physically exists in terms of premises, staff and equipment.[44]

While the relevant provisions of the Finance Act 2015 are drafted deliberately narrowly, it may well be the case that, if subjected to the scrutiny of the ECJ, the scope of the tax narrows even further. On that basis, it is entirely possible that many of the arrangements that the tax is purportedly designed to target fall outwith its scope by virtue of being rooted in economic reality.

---

[40] Tran, 'Cadbury Schweppes plc v. Commissioners of Inland Revenue: Eliminating a Harmful Tax Practice or Encouraging Multinationals to Shop around the Bloc' *Loyola L.A. International and Comparative Law Review* (2008): 77.
[41] Gordon, *supra* note 24: 800.
[42] *Ibid.*: 802.
[43] *Ibid*.
[44] *Cadbury Schweppes*, *supra* note 32.

While the diverted profits tax may have attracted the moniker of 'the Google Tax', the reality is that the arrangements of Google, like so many other enterprises that have been the subject of much public and political ire, are not, in fact, artificial at all. As of end 2013 Apple has 4,000 employees in Ireland; Google has over 2,000; Facebook approximately 500. These are hardly brass-plate companies, but real and substantive establishments within Ireland.

It is difficult to see how the practice of lawfully 'booking' profits in a jurisdiction in which an enterprise has thousands of employees could nonetheless be construed as being artificial. By contrast, it is arguable that to exercise tax jurisdiction over an enterprise which has as its sole connection with that jurisdiction the fact that it makes sales within it is, in fact, highly artificial.

Furthermore, it is difficult to envisage how the DPT will be enforced, in practice, over enterprises with absolutely no presence in the United Kingdom whatsoever. Compelling compliance from enterprises that have no physical presence within the UK and conduct their dealings entirely through the Internet and independent agents may well prove extremely problematic. While there is no reason to believe that enterprises will seek to break the law, it may be rather more difficult to persuade those enterprises to voluntarily comply with a tax that rests on such questionable legal foundations – in particular if those enterprises contest the legality of the DPT under double tax treaties.

5. Conclusion

The diverted profits tax appears to be extremely problematic with respect to both international and EU law.

Insofar as the United Kingdom's obligations under its double taxation conventions are concerned, almost all such conventions purport to have effect over taxes that are the same as or substantially similar to taxes covered by that convention. It is difficult to sustain the argument that the DPT is an entirely different tax from corporation tax, notwithstanding the decision in *Bricom*, given that the charging provisions for the tax are directly imported from the Corporation Tax Act 2009.

Insofar as EU law is concerned, the DPT is only compatible with the treaties insofar as the tax targets wholly artificial arrangements. However, s87 of the Act extends the tax to arrangements that have as their main purpose or one of their main purposes the avoidance of tax. This broad scope runs contrary to a string of ECJ jurisprudence that provides that such restrictions can only be placed on wholly artificial arrangements – that is to say, arrangements that have avoidance of tax as their *sole* purpose, and that lack any economic substance whatsoever.

In most instances, however, those arrangements that the DPT seeks to target do indeed have at least some economic substance. In the case of many online enterprises who book profits through the Republic of Ireland, their arrangements have considerable economic substance, and are therefore taking advantage of free movement rights under the EU treaties. On that basis, these enterprises will likely never find themselves required to pay the diverted profits tax, and if they were, they would most likely succeed in challenging the lawfulness of such a charge under EU law. It may be that we need to find another nickname for the ‘Google Tax’.